A NEGATIVE FISCAL MULTIPLIER?

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August 2001

Discussion Paper No. 293

ISSN 1033-4661

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The so-called negative fiscal multiplier concept comes from the neo-classical free market economic philosophy and is found useful in arguing that fiscal stabilisation policy may produce results contrary to those expected under Keynesian analysis in which the (positive) fiscal multiplier has traditionally been accepted as the norm. As a result, "fiscal consolidation" (FC hereafter), that is, the creation and maintenance of the classical balanced budget, ensures that fiscal policy cannot be used for stabilising the economy . Indeed, any attempt to do so will be harmful.1 This idea has been advanced and research into its possible existence during the last twenty years has produced some encouraging results. This paper examines this research in further detail.

Key Terms:
(JEL code: I 31)

1 Why could not Fiscal Consolidation, which implies that something is necessarily wrong, have been called Fiscal Reconstruction, which is not highly emotive? It is also necessary to differentiate at first between the two concepts which become intertwined in the analysis: fiscal consolidation and the fiscal multiplier, The first involves a reconstruction of fiscal policy - a long-run process concerned with immense changes in attitudes with long-run implications and especially the attainment over time of a budget surplus. The fiscal multiplier analysis is relatively short-run and involves the impact on GDP of an attempt to alter the level of government expenditure or taxation as part of the government's stabilisation policy. It is with the latter that we are concerned with in this paper even though such a change in either variable may also be a step towards (or away from) fiscal consolidation, but only one step at a time.

SOME INTRODUCTORY REMARKS

Consider the effects of a rundown of a country's public debt accumulated over several years as a result of deficit budgeting. Suppose the government of a country undertakes an FC programme by introducing a budget containing reduced public expenditure, for example, by running down its consumption expenditure, downsizing its labour force, reducing its transfers to the unemployed, the aged, and to other unfortunates, or by cutting back capital works. In analysing the impact of such a reduction, let us follow the two main arguments.

First, by the Keynesian approach, reducing government expenditure by itself acts directly and adversely on GDP. The multiplier effects occur when those affected in the private sector by reduced income must also cut back their expenditure out of lower incomes and thus help to influence GDP adversely (a positive fiscal multiplier) and/or have a negative impact on the balance of payments or the exchange rate, if floating exchange rate policy is being followed. On the other hand, this argument is dismissed completely by the second approach. The reduction in the public debt with a lower deficit reduces the public sector demand for loans and this reduces interest rates. Lower interest rates attract private borrowing for investment, which will increase GDP. If it is expected that the government's actions will be beneficial to the economy, the latter will be reinforced. This is where the negative fiscal multiplier enters the argument: by reducing government expenditure, GDP rises, because any multiplier which may be relevant is negative.[2] Similar arguments apply if increased taxation is used as a means

2 Economic theory has produced numerous models to demonstrate the impact of fiscal policy and monetary policy on GDP and the balance of payments. From the Mundell-Fleming models (fn) it has been suggested that fiscal policy works best under a fixed exchange rate regime, being rather limited in its application under floating rates (especially if capital is highly mobile). Monetary policy (interest rate policy) has its greatest impact under floating exchange rates and is rather poor in its applications under a fixed rate system. The latter also has its problems as there is a lagged response in terms of GDP changes which may extend up to 15 months in duration. It also works best if capital flows are highly mobile.

of running down the budget deficit.[3]

There are numerous extensions of the neo-classical approach - all couched as models which are very flexible and streamlined in theory.[4] There are, however, at least two types of comments about this model, which spring to mind. First, do business firms and consumers react as quickly as the model suggests to any change in government policy and are all members of society perfectly *au fait* with neo-classical macroeconomic thinking so as to react instantaneously to government policy changes? One would expect that only a very small proportion of the population (for obvious reasons) would be 'rational' enough to see all the pros and cons of the changes involved. In addition, one could predict that, to implement the changes, there would be many obstacles to overcome which in theory are easily brushed aside, including the *ceteris paribus* assumption in the economic analysis.

Second, a recent comment by Robert Theobald appears appropriate here:

> "The acceptance of economic thinking ... and the current worship of free markets as the source of all good is, without doubt, the most extraordinary triumph of theory over reality in human history." (*Business History Review,* 5 November, 1999, p. 52.)

In the current adulation of the business firm, the numbers of failed businesses, headed by inadequate and/or self-seeking CEOs, do not receive sufficient, if any, attention.

So we have alternative macroeconomic approaches but the one favoured at the moment and the one which accords best with the modern laissez faire is the neo-classical approach. But which of the two in reality will produce the desired ends?

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3 "The neo-classical hypothesis suggests that determined action to reduce the budget deficit ('fiscal consolidation') would give the public at large confidence that the government is finally getting its house in order and will be borrowing less in the future, thereby lowering interest rates throughout the economy. This would spur businessmen and investors into economic activity ... during the immediate period of fiscal consolidation. If this view is correct, and politicians can be convinced that reducing the budget deficit would not impose a severe penalty on economic growth, there would be less political inclination to delay reforms needed in deficit countries." (McDermott, C. John and Wescott, Robert F., 1996, p.3), The authors have thus assumed their conclusions are correct before proving such is the case.

4 See article by Tony Makin, 1998, pp. 419-426, and extensions to the model.

One could argue that the outcome would result from the different strengths of the two approaches, each having an impact on economic activity. Together, they cover the impact on demand and on supply factors. However, whole-heartedly embracing the second ignores the proposition that there are weaknesses in this approach in some of its crucial steps. Why should a reduction in public demand for loans necessarily reduce the domestic rate of interest in a world of open free capital markets? Why should there occur a desire for businesses immediately to expand investment?

The **willingness** of the business sector to invest is **not absolutely** identical with its **ability** to invest. The demand side of the equation must be considered along with the supply side. And this appears to be a **crucial** weakness of this neo-classical argument. The only situation in which investment expenditure would increase is if businessmen **expected** a rise in GDP irrespective of government fiscal policy, that is, if renewed economic growth (or recovery) and rising demand were anticipated, and if so, it would be entirely separate from the public retrenchment. In addition, such investment expenditure would occur only after a lengthy lag and, especially if it involved the implementation of fixed investment.

The negative fiscal multiplier argument as presented in the literature also relies on the manipulation of statistical data in such a way that only 'structural' features of the economy are considered, that is, after the elimination of the cyclical aspects of the statistical series, as are existing expansionary pressures. It also appears that every other factor which could cause investment to rise, for GDP to expand, for the public debt to decline, are assumed away.[5] These features of the analysis aimed at proving the existence of a "negative" fiscal multiplier

5 See comment on the structural approach in IMF, World Economic Survey, October 1998, p. 93, f.n.. 2: "The structural budget position is defined as the actual budget deficit (or surplus) less the effects of cyclical deviations of output from potential output. Because of the margin of uncertainty that attaches to estimates of cyclical gaps and to tax and expenditure elasticities with respect to national income, indicators of structural budget positions should be interpreted as broad orders of magnitude. Moreover, it is important to note that changes in structural budget balances are not necessarily attributable to policy changes but may reflect the built-in momentum of existing expenditure programs. In the period beyond that for which specific consolidation programs exist, it is assumed that the structural deficit remains unchanged."

favour the discovery of such a phenomenon, perhaps to the detriment of the more appropriate determinants.

EMPIRICAL EVIDENCE

The search for the existence of the NFM in reality found that in three cases out of the sixty-odd examined there was substantial evidence of success. This is not encouraging. It was explained that a negative fiscal multiplier would most likely occur if a reduction in government expenditure (desirably consumption expenditure and/or transfers) occurred in a period of economic expansion.[6] Let us continue the discussion by referring to the three so-called highly successful cases: Denmark (1983-86), Ireland (1986-89), and New Zealand (1992-95). Let us also consider the actual situations in these three countries and not the highly drawn situations of the proponents.[7] We must also consider the *caveats* noted above.

The Case of Denmark: 1982-86[8]

McDermott and Wescott (p. 11) note that the primary budget deficit in Denmark in the early 1980s was around 6.5 per cent of GDP, and argue that, as a result, a sharp FC began in 1982 and in the next four years reduced the *structural* primary deficit (as a share of GDP) by 10 per cent, yet the economy expanded, and the consumption to GDP ratio rose by several

6 If so, however, the ceteris paribus aspects of the model would not apply. Other factors would also be operating on GDP and thus the NFM would have no substance.

7 See McDermott and Wescott, op. cit. for explanations of all the possible cases, including the three that stood out. Of the three countries studied below, only New Zealand could claim to follow a floating exchange rate policy during its relevant period. The situations regarding the other two are not clear cut and require special noting. Both countries were members of the European Exchange Rate Mechanism (ERM), under which member currencies followed a strict course tied to the ECU (European Currency Unit). While the ECU floated against the U.S. dollar as did all member currencies comprising the ERM, each currency also followed an 'adjustable peg' (virtually a fixed) exchange rate system vis-a-vis the others in the system. In reality the Danish and Irish currencies were almost fixed in terms of the other five (whose countries held important markets for their goods and from whom capital funds were readily available).Thus domestic policies in these two countries had a very limited impact upon each country's currency; rather the impact can be seen principally in each country's international currency reserves. Neither country had a major influence on the movements of the ECU as the economic activities of the larger members, Germany, France, Italy, and the Netherlands influenced the snake's movements most of all. The kroner and the Irish pound responded to the movements of the ECU rather than determining such movements. New Zealand's case was different and its situation will be discussed separately below.

8 See McDermott and Wescott, ibid., p. 50. In 1982, however, FC did not start before October with the new budget and other measures.

percentage points. Were the changes *solely* attributable to the reduced budget deficit?

It is noted that towards the end of 1982, the Danish economy, along with most of its neighbours,[9] recovered from the recession of the early 1980s *before FC could have had any influence on economic activity* and experienced economic growth in mid-decade. Nevertheless, the slump which occurred in 1986 and the following years virtually until 1994, was not common within the European Union, certainly not in the late eighties. On economic activity in general, there is the suggestion that natural recovery and growth forces were at work between 1982 and 1986 and that, whatever FC forces were exerted on GDP, such forces may have been transitory or less intense than the above authors argue.

> 'The turnaround in the government's budget from deficit to surplus beats that in any other OECD country. But **only half of the improvement was the result of tighter fiscal policies.** Much of the rest reflected **a boom in economic activity that has automatically raised tax receipts .... a faster pace of domestic demand caused the current account deficit to widen.'**[10] (*The Economist*, 3/09/88, p. 70)

The primary budget balance could not be consolidated as the figures after 1986 show a sustained return to massive deficits which continued into the 1990s.[11]

What were the intentions of the Danish government in 1982? A change in government occurred in October leading to a new economic strategy incorporated in the following March budget, aimed at 'fostering growth and employment while eliminating the current external imbalance and eventually reduce foreign indebtedness.' At first there was an attempt to reduce inflation, improve the public finances, adopt 'a tighter incomes policy to reduce the domestic costs and price increases and to ensure better international competitiveness.' Externally, a 'firm' exchange rate policy was introduced to moderate inflationary

9 For example, Norway, without FC, recorded annual percentages of 0.9 per cent in 1981 and 0.3 per cent in 1982, followed by 4.6, 5.7, 5.3, and 4.2 per cent from 1983 to 1986, roughly mirroring the Danish performance. See OECD, World Economic Outlook, 1996, p. A4..

10 How the 'half' was calculated was not revealed.

11 In the last three years of the 1980s, the budget surplus fell each year, becoming negative in 1990 after which year the budget deficit expanded to exceed 50 billion kroner by 1994.

expectations (OECD. *Economic Survey: Denmark*, 1984).[12] It is to be noted that FC formed only a part of the new strategy.

As a result of the new approach, the budget balance improved from some kr30 billion deficit in 1982 to over kr30 billion surplus in 1986.[13] To achieve this result, taxation revenue increased in every year but so too did expenditure. The improvement came about because the increases in taxation greatly exceeded those in revenue, especially in 1986. In addition the accumulation of surpluses reduced the public debt which had risen to a peak in 1982, much of it being foreign debt.[14]

While not all of the capital inflow can be attributed to government borrowing, the size of the annual inflow demonstrates that crowding out forces within the domestic capital market were weak during these years, for both the government and the private sector found foreign capital markets very accessible.[15]

So far, the evidence, using actual National Accounts figures, suggest that the forces underlying the neo-classical case may be weak in that taxation not expenditure formed the basis for a declining deficit, that expenditure did not fall absolutely during the period under discussion. Under the NFM sequence of events, the decline in the fiscal deficit should lead through interest rate decreases (as the Government's demand for domestic loanable funds falls) to increases in private investment which would favour increased growth of GDP. Interest rates were falling, as they were throughout Europe, but not primarily, it seems, in

12 Nevertheless the kroner remained in the ERM.
13 Of the several estimates appropriate for this paragraph, the OECD, Quarterly National Accounts, 1996, No.2, pp. 375ff. have been used.
14 According to the OECD, ibid., the net borrowing from the rest of the world yearly from 1982 to 1986 was kr20b., kr14b., kr19b., kr29b. and kr37b. The kroner fell in value from 1980 to the end of 1984 but then appreciated to 1987. Thus, borrowing abroad, at least for a while after 1984, could have been quite profitable.
15 Denmark's foreign debt stood at 30 per cent of GDP in 1981, "much of it public borrowing to finance budget deficits" (The Economist, 13/04/85, p. 16). This source went on to assert that the foreign debt at that stage was becoming so large that the interest payments on it still contributed to the large current account deficits. See also OECD, Economic Survey: Denmark, 1987/88, p. 76, f.n. 14.

response to government fiscal action.[16] Thus investors must believe that the reduction in the fiscal deficit was encouraging before they would increase their investment expenditure - a more nebulous proposition. As it happened, gross fixed investment rose in every year from 1981 to 1986, but most rapidly in 1984, 1985, and 1986, after which year it fell (in current and constant prices) (OECD, *ibid.,* pp. 120, 121)..[17] Nevertheless, although interest rates did decline, there appears little evidence that they were substantially affected by FC during this period. At least two reasons could account for this. First, the government could have borrowed extensively abroad and second, the central bank operated a very liberal monetary policy ostensibly to offset the tight fiscal policy.

> The government's mistake was running a permissive monetary policy along with a strict fiscal one. The money supply rose by 25 per cent in 1983 bank credit had begun to expand as well. The lax monetary policy **prompted** a sharp recovery in **private sector demand**, which in turn is the cause of the alarming increase in imports. (*The Economist,* 30 June, 1984, p. 59)[18]

In addition, to encouraging higher consumer spending, the increasing funds in the country no doubt helped to reduce interest rates. At the same time, personal consumption rose in every year from 1982 to 1987 (in the last of these years the budget deficit began to expand again),[19] although it grew more slowly than GDP, during a period in which consumer prices were falling.[20]

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16 The official discount rate was reduced from eleven per cent to ten per cent in November 1982, to 8.5 per cent in March 1983, 7.5 per cent the following month and to seven per cent in May. From October 1983 throughout the rest of the period it was held at this level. In addition, other interest rates tended to fluctuate but in a downward direction during much of the period. The long-term bond yield declined progressively from a peak of 21.3 per cent in May 1982 until the end of 1983 when it recorded 13 per cent. After some variations around this level for some time it slowly fell after March 1985 to reach its nadir in April 1896 at 9.2 per cent. Thereafter it rose. Note that, in 1982 and the next four years, interest rates fell in all industrial countries. (see IMF, Monthly Economic Indicators, various issues). Clearly a common factor was at work at this time.

17 In constant prices terms, much of the increase was in 'machinery and equipment' (ibid.).

18 Despite the reductions in the money supply at the beginning of 1984, it maintained a high rate of growth which was not reduced below 10 per cent for the first time during the 1980s until late in 1986.

19 It is also apparent that, despite the large increase in the consumption to GDP ratio stated by McDermott and Wescott (see above), some statistics suggest that from 1982 to 1986, the ratio of private consumption expenditure to GDP remained remarkably stable at around 54 per cent in current and constant 1980 prices terms (see OECD, Quarterly National Accounts, 1996, no. 2, pp. 114, 115).

20 The annual increase in consumer prices had begun to fall as early as 1981, but it fell sharply in 1983 and again in 1984.

It does seem possible that investors may have been encouraged by other factors as much as or more than by the expectations they had from the reduction in the budget deficit. In addition to the above, one has to consider the impact of the government wages legislation which saw the abolition of wage indexation in October 1982 and the restriction on the growth of government workers' wages to four per cent a year late in 1982 in line with the trend in the private sector.[21] From 1983 to 1985 at least the annual increases in hourly earnings were below the rate of inflation, a reduction in production costs benefiting Danish producers, tending to improve their competitiveness *domestically* and *vis-a-vis* their foreign counterparts. The kroner depreciated by almost half *vis-a-vis* the U.S. dollar from 1980 to 1984, favouring Danish exporters to non-EU markets but a strong appreciation of the currency after 1984 tended somewhat to offset this advantage. In addition, the state of the European economy must have had some influence even if only to the extent that the trends in many Danish economic series merely mirrored those in the series of other countries or country groups where fiscal consolidation was not being pursued so dogmatically.

Finally, there is the question of lags. Taking into account that the change in government in October 1982 and that the new approach to fiscal policy were unanticipated, the introduction of the new policy could not have influenced businessmen overnight. They could not suddenly decide that a brighter future meant that they could implement new investment programmes immediately. For example, it would have taken several months before the change in government finances would have taken place and the impact on interest rates become evident. Even so, private investment in extensions to works or new plant would take some time to arrange, even though the portents were correct. The neo-classical approach has not taken into account these and other lags associated with sudden change. Nor has it recognised that private firms would have had to possess some knowledge of the possible trend in the demand for its additional output, either domestically or abroad.

21 According to The Economist (23/11/85), Danish workers experienced a fall in real earnings for five successive years to 1984, followed by a modest rise in 1985.

The sequence of events required to maintain the NFM argument did not occur in the Danish case; other factors were also determining events during this time.

Taking all the remarks above into account, it is not a foregone conclusion that what happened in the Danish economy in the mid-1980s was solely the result of the FC, or that the upward trends of 1982 and 1983 were wholly determined by the government. Other growth-generating forces were at work. Moreover, it is inevitable that natural forces aided the recovery from the recession of 1980-81, as would have the inbuilt budget stabilizers, rarely mentioned by the neo-classicals.

The Case of Ireland: 1987-90

McDermott and Wescott note (p. 11) that Ireland had attempted FC in 1982 and that, by 1984, the structural primary budget deficit had been reduced by seven per cent of GDP mainly with the use of higher taxes. But output fell along Keynesian lines![22] The next attempt at FC began in 1987 with reliance on large cuts in government consumption expenditure. The result was a decline in the budget deficit-to-GDP ratio from 1987 to 1989 with an expansionary boost to output and nearly a 20 per cent reduction in the ratio of gross public debt to GDP. The changes in the two periods are remarkable with a suggestion to the sceptics of the involvement of other factors. In this respect, the OECD noted that, during the latter period, Ireland achieved rapid economic growth, falling unemployment, and improving performances in exports and the balance of payments. It went on to note:

> "The adoption of medium-term strategy of **wage moderation**, **fiscal restraint**, and **narrow-band membership of the ERM**, provided the **policy basis for these developments,** although they also **owed much to a favourable external**

22 Not all commentators would describe the result of this first effort as a failure, although executed along Keynesian lines. Presumably it failed because it did not result in the neo-classical conclusion.

environment. (OECD, *Economic Survey: Ireland, 1992-93*, p. 9)[23]

If this statement is a true reflection of the situation at the time, it is impossible to allocate the events of the period to only one of the forces at work at the time. It seems that *ceteris paribus* did not prevail.

Ireland's real GDP rose rapidly in 1987, following the small, absolute, decline in 1986 and such growth continued through to 1990, being higher in the last two years. (OECD, *Historical Statistics*, various) Because of this expansion, unemployment fell even if slowly from a peak of 19.5 per cent of the labour force in May 1987 to around 17 per cent in 1990.[24]

Other figures, for example, GDP per capita and productivity (GDP per worker) also rose, with the largest increases occurring in 1989 and 1990, the years of the highest real GDP advances. At the same time, consumer price increases remained below four per cent while average weekly earnings rose annually at a decreasing rate from 7.5 per cent in 1986 to 3.8 per cent in 1990. In the latter year, wages tended to stagnate. The labour market was somewhat depressed during the whole period, despite the moderate fall in unemployment, a feature reflected in workers' earnings. On workers' earnings, it must be noted that the October 1987 agreement between the government and the unions to the effect that wage increases would not exceed 2.5 per cent in any of the next three years was undoubtedly the main cause of the real hourly earnings in manufacturing failing to exceed 2.5 per cent in any year from 1987 and 1993.[25] Such wage restraint no doubt placed a limit on cost increases and made businesses more competitive relative to their foreign counterparts, but wage policy was

23 Also see ibid., 1990-91, p. 31: 'The good performance of the Irish economy over the past four years has been the result of a combination of favourable influences which have been mutually reinforcing ...' Note that, in the years 1987 to 1990, GDP rose faster than at any time in the last 20 years (to the present date). Although GDP for the EU as a whole was relatively high in 1988 and 1989, the figures for Ireland were much higher in these two years.

24 Note, however, the use of Ireland's unemployment figures is suspect to the extent that a large amount of emigration and immigration was occurring during these years.

25 See OECD, Economic Survey: Ireland, Annex Table 13, various issues. See also ibid.., p. 21: 'As a result of comparatively modest increases in real wage rates, Ireland's competitive position, as measured by movements in relative unit labour costs in manufacturing in a common currency, has strengthened.

separate from the NFM argument, even if it was a condition for FC to work.

Whereas real private consumption spending rose rapidly from 1986 to 1988 as a reaction to tax cuts and lower interest rates, its rate of growth fell substantially in the next two years. In addition, private final consumption expenditure as a percentage of GDP fell slowly from 1986 to 1990. Whereas real gross fixed capital formation declined absolutely after 1981 in almost every year until 1989, it rose sharply in the latter year by 12.8 per cent and 12 per cent in 1990. Whatever produced the increases in GDP in 1987 and 1988, it seems that investment expenditure, supposedly the prime mover of increased economic activity as domestic interest rates fell in response to the government's reduced demand for funds as its deficit declined, played little part. But interest rates followed a different path. Most series fluctuated widely in 1985 and 1986 then fell rapidly in the first half of 1987, bottomed out in the second half of 1988, then rose until the end of the period. Indeed, it was during the period of rising interest rates that private investment began to **increase most markedly!** At the same time, inflation was not of great concern to policy makers.

Before considering the strengths of other factors, including those arising out of trade and foreign investment activity, let us consider carefully the changing budgetary scene. In terms of FC (not in structural terms, which would not have been understood by non-economists), despite the IMF research arguments,[26] the central government's current budget balance improved by over IR£1 billion[27] from 1987 to 1990 (both inclusive), mostly in 1988. The major contribution to this improvement came from the increases in tax revenue (£1.1 billion) rather than reduced expenditure. Indeed government expenditure increased by some £700 million during these years[28]

26 See IMF, Can fiscal consolidation be expansionary in the short-run? World Economic Outlook, May 1995, Box 2.
27 In the section on Ireland, Irish currency will be used.
28 Figures are derived from the United Nations, National Accounts Statistics, 1994, pp. 889-909. Also see OECD, Economic Survey: Ireland, various issues.

These changes meant that net (Exchequer) government borrowing, while positive in every year, was reduced from £2.15 billion in 1987 to £460 million in 1990. It was in March 1987 that the new Haughey government began to change the nature of the government budget. While it would have been some time before these changes could have made any impression on economic activity, except for business and other expectations, the movement in the domestic debt did not change direction until 1988 and thus interest rates would not have fallen directly as a result of the move to FC until then.[29] Thus the chain in the NFM argument was broken. Other factors must have accounted for the direction of interest rate changes in these years! The big influence originated perhaps in the external sector.

Before considering the trade sector it is important to note another relevant factor which has had little attention in the literature, that is, the realignment of the Irish pound against other currencies. The Irish currency was devalued by eight per cent against other European currencies on 2 August 1986 while the upward revaluations in the following January of the German mark and the guilder (of three per cent) and of the Belgian franc of two per cent should have had some positive effects on the Irish trade figures and those of GDP as well (OECD, *Economic Survey: Ireland*, 1988/89, p. 25). Of these external economic changes and other factors, exports perhaps provided the greatest influence on GDP and other economic variables at this time. They increased from 52.7 per cent of GDP in 1986 to 63.5 per cent in 1989, then fell back to 59.5 per cent in the following year. (OECD, *Historical Statistics*, 1960-1993). It is difficult to argue that export growth was directly related to FC performance.[30] After some fluctuations in 1985 and to mid-1986, a definite upward movement began in exports in July 1986, continuing until 1990. Imports followed with a lag, especially after January 1988. In other words, export expansion began well before the

29 It was a period of changing Exchequer loans from foreign sources to domestic sources for the Exchequer foreign debt fell from £49 billion in 1986 to £34 billion in 1990 whereas domestic debt rose from £66 billion in 1986 to £69 billion in 1988 before falling to £62 billion in 1990. It is therefore not clear that the rise in domestic debt could have contributed to a decline in domestic interest rates until 1989! See OECD, Economic Survey: Ireland, 1992-93, p. 46.

30 It is useful to note that in the late 1980s, 46 per cent of Ireland's manufacturing employees worked for foreign multinationals who also accounted for 80 per cent of Ireland's non-food exports and most exported their output (90 per cent of the American firms). These firms must have played an important part in export expansion and its contribution to GDP.

government's new approach to FC in 1987.[31] Indeed, investment decisions of the multinationals operating in Ireland would have been influenced little by changes in domestic interest rates.

Returning to the NFM argument, the following comments are relevant. In the fall in the budget deficit, changes in both taxation and expenditure contributed, the former predominating (as it had done before in the early 1980s). Second, reductions in the rate of growth of government expenditure did not lead to reductions in social service payments which rose slowly except on 1989 when a slight fall did occur. Thus expenditure from this source would not have fallen substantially. Third, the notion that 'crowding-in' occurred, allowing interest rates to fall and thus private investment expenditure to rise, was well wide of the mark for this period. Interest rates did fall for much of the period but mainly in response to the downward trends abroad and not as a result of changes in the Government borrowing programmes. Fourth, following on, it is evident that the decline in the fiscal deficit had little domestic influence for, as noted above, until 1989, 'Exchequer' domestic debt actually rose: it was the foreign debt which was first to be reduced, by £16 billion from 1986 to 1990 at a time when the domestic debt was reduced by some £3.3 billion (having increased to a peak in 1988).[32] **The favourable impact of the reduced budget deficit on domestic interest rates just did not happen, at least until 1989.** Fifth, by Keynesian decrees, consumption expenditure should have continued to grow until 1988 because of the continuing deficit and the increased domestic debt and then declined. Indeed, its rate of growth in real terms rose until 1989, after which year it fell.

Finally, there appears little more that could be advanced in support of the NFM argument. While it has some validity, its strength is much weaker than has been maintained. It failed in

31 One could argue that the restrictions on wages which could have increased industrial competitiveness, may have affected exports favourably and thus contributed to their increases. Against this however is the increase in imports which cannot be explained in this way.

32 In 1989 and 1990, the reduced domestic debt amounted to £4.6 billion and £3.3 billion respectively. These debt figures come from the Table on "Foreign and Domestic Debt and Debt Servicing: Exchequer Debt", in OECD, Economic Survey: Ireland, 1990-91, p. 129.

one of its crucial stages: the rise of *domestic* debt, a feature which could **not** have accounted for the decline in interest rates. Other factors were also important. In addition to the OECD comment noted in footnote reference 19 above, in another context, the OECD concluded:

> "Ireland has recovered strongly and, as a result of productivity gains and wage moderation, profitability and international competitiveness improved .... This good performance .... has also owed a great deal to a favourable world trading environment, in which rising export demand, buoyant tax revenues, and lower interest rates have made the goal of reducing government and external balances easier to attain." (OECD, *Economic Survey: Ireland*, 1990-91, p. 9).

There are several favourable influences here that are not related to fiscal adjustment.

The Case of New Zealand: 1992-95

According to McDermott and Wescott:

> New Zealand's fiscal position shifted from a deficit of 5 per cent of GDP in 1992 to a surplus of 3 per cent of GDP in 1995, reflecting *above all else* structural measures that strengthened expenditure control. While revenue remained stable, expenditure as a share of GDP dropped by 10 percentage points over these years. Interest rates declined significantly. Despite the fiscal contraction, GDP growth revived - from *minus* 2.5 per cent in 1992 to *plus* 5.4 per cent in 1995 - while the unemployment rate was cut in half. Meanwhile the ratio of public debt to GDP dropped to 38 per cent from 52 per cent (McDermott and Wescott, *op. cit.*, pp.10-1. My italics).

The unusual phrase here is "above all else", partly an admission that other factors could have contributed to the results mentioned but such factors receive no mention nor are they therefore compared with FC as determining forces. Nevertheless, let us update the statements made by the authors. First, the change in the budget position was from a deficit of 1.7 per cent of GDP to a surplus of 5.9 per cent. Revenue actually rose - by as much as 23 per cent, while government expenditure fell by only six per cent. Thus, in the fiscal consolidation, government revenue led expenditure. Interest rates had been declining substantially since the end of 1990 and the trend was not primarily **caused** by the changing fiscal balance. Indeed the fall in interest rates ended in the first quarter of 1994 and subsequently an almost

doubling of rates occurred by the end of that year. There was no sudden change in interest rates following the improving government balance and the decline in the government's demand for funds, but the expectations of further falls were in the market. Investment should have responded to the interest rate decline from 1991 on, but it did not. Indeed, its highest level occurred in 1994 when interest rates were rising! Furthermore, the declining budget deficit should have reduced interest rates in 1994 and 1995, but this did not happen. Also, the rise in interest rates in these years should have had a depressing effect on private investment but, once again, it did not, suggesting that other, perhaps more important, factors were at work or that private investment was not so interest-sensitive at that time. One other factor which may have affected private investment was the switch of the government in its public debt with a decline in the foreign component and an *increase* in the domestic debt.[33] This rising domestic debt would not have had the favourable impact associated with the NFM argument. Indeed, the *increased* government demand for internal funds would have had the opposite effect! A curious fact about the NFM analysis is that even though interest rates were falling internally until 1994, they were doing so at the same time as internal government debt was rising. Where, therefore, came the pressures for increasing private investment at this time? Perhaps it would have been only through the nebulous expectations of future trends from declining government deficits. Was the business sector so sensitive to possible future events and trends?

At this stage it should be noted that New Zealand's GDP rose in 1992 (giving the possibility of a NFM example) as the economy recovered from a protracted recession in the four previous years, in two of which GDP actually declined.**(** **I**nternational Monetary Fund, *World Economic Outlook,* May 1997, p. 132).[34] The years 1993 to 1995 were good years; GDP rose at over five per cent in the last two years, the best for many years. In its 1992-93 survey of the New Zealand economy the OECD noted:

33 External government debt fell from NZ$20.6 billion in 1990 progressively to $13 billion in 1995, during which period the total debt fell very marginally, while domestic debt rose from $23.8 billion to $31.1 billion.
34 From 1989 to 1992 the annual (calendar year) percentage growth rates were 0.8, -0.2, -1.7, and 0.9.

> The economy turned around in the third quarter of 1991, as domestic demand bottomed out and strong export growth continued. New Zealand's competitive position has improved markedly over the past two years. **This has resulted from price factors stemming from low wage and price inflation combined with an exchange-rate depreciation (**OECD**,** *Economic Survey, New Zealand*, 1992-93, pp. 115-6).

In other words, domestic demand was recovering, exports expanding, wages stationary, and the rate of exchange declining. The Report went on to explain this economic state as being derived from all the reforms undertaken during the previous decade along *laissez-faire* lines. This claim was repeated in the following year. It was not claimed in any year that the state of the economy resulted from a decrease in government expenditure in the 1992-94 years to wipe out a fiscal deficit. By 1999, it appears, New Zealand economists were still debating whether the upturn in the economy in these years was a reaction to the (cyclical?) decline of 1990 and 1991, a natural recovery, or wholly the result of the changes in the government's budgetary policy of previous years.[35] Yet, however much the structural changes may have contributed to the changes in 1992-95, such contributions have little relevance for the NFM thesis which must relate to changes which occurred no earlier than 1992.[36]

Some Conclusions

It is clear that a strong case for a negative fiscal multiplier has not been established in the three cases examined. That does not mean that we can exclude the possibility of such a phenomenon in other instances, but it does appear that such may be difficult to locate, for a

35 See the New Zealand Year Book for 1998, pp. 367ff. It concluded that the effectiveness of reforms remained inconclusive (p. 369). This argument, based on the previous reforms of the past began to wear thin in 1995 in which year New Zealand's growth rate began to decline, at first from the six per cent recorded in 1994 to four per cent, followed in the next three years by 3.1, 2.1, and -0.3 per cent, while exports, which were hailed as the perfect variable for exemplifying the increased competitiveness of the country's industries from the reforms of previous years, rose slowly in 1990 and 1991, but increased rapidly in 1993 and 1994, seemingly justifying the common argument of the time. The increased competitiveness argument does not explain the drastic fall in the rate of growth of New Zealand's exports in 1996 (5.1 per cent) and their absolute decline of 2.2 per cent in 1997 nor does it explain the buoyant commodity imports through the same period, when increased industry competitiveness should have led to much import substitution. But imports also fell in 1997. (Trade figures are in current prices) On the other hand, the exchange rate, which was falling from 1990 to the end of 1992 and was then rising right through to 1997 may have been the important determining factor at the time.

36 Then again, if all the structural reforms 'of previous years' had accounted for all the improvements in the NZ economy up to 1995, why has economic performance been so miserable since - was that also a result of the structural reform? Or are we to ascribe all the good things that happen to structural reform and all the bad things to other forces?

number of reasons.

First, in the application of their model to the real world, the IMF authors were unable to make use of the assumption of *ceteris paribus*. Second, it appears that the NFM's existence may be restricted to a situation in which some economic expansion is under way or if the economy is proceeding out of a recession. This was so for each of the countries examined above. Moreover, the two advocates for the NFM virtually agree that such may be necessary.[37] Third, the possible existence of automatic fiscal stabilisers is not recognised. Finally, the strict adherence to the theory does not allow the required conclusions to be reached. To prove the point one must follow the strict sequences of events required by the theoretical model.

Despite these comments, there appears to be some logic in the concept. It is possible that the real situation at any relevant period of time requires a balancing of the two approaches to fiscal change, namely, its impact on demand and also on supply; whichever is the stronger would determine the sign of any existing fiscal multiplier. Perhaps this may be the answer as to why the analytical results have diverged from one country to another.38

37 See Fiscal reforms that work, p. 10: '...strong global economic growth helps to achieve successful consolidation, and weak global growth reduces the chances that consolidation will cut the debt-to-GDP ratio.' Whence the ceteris paribus assumption here!

38 Some other instances which may require comment include the use of fiscal policy to overcome Japan's economic problems throughout the 1990s. Fiscal stimulus does not appear to have achieved any positive results but neither did monetary policy which led to the lowest interest rates in the industrial world. The Japanese Target call rate was lowered to zero per cent recently and has been below 0.5 per cent at least since 1995. The answers of course include the deep-seated economic problems confronting Japan with heavily indebted financial institutions unable to respond to any government stimulus, and other causes, rather than a purely cyclical problem. Australia appears to have gained from fiscal consolidation in recent years, (at least it has, for what it is worth, run several budget surpluses) but this is part of structural reform rather than a case in which the possibility of a negative fiscal multiplier has been evident. But it is one case which requires analysis in the future.

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